DOW THEORY LETTERS INC.

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THE MARKET: According to Dow's Theory, reliable inferences may be drawn only after consideration of the movements of both Averages. Although few people are aware of it, the Averages recorded their last confirmed highs on October 20 (this was discussed in detail in Letter 279). A mild secondary reaction carried into late December with Industrials and Rails establishing lows (see Chart 1) of 857.45 and 203.51.

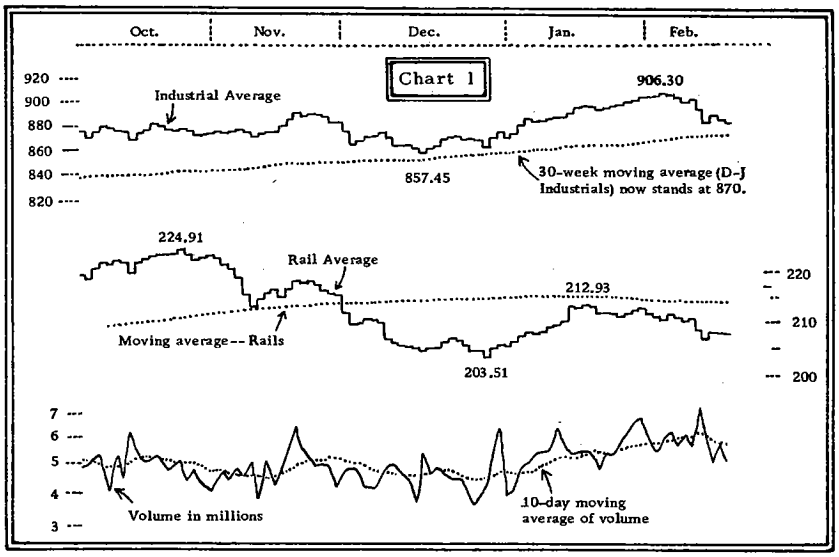
A recovery began in January. By February 3 the Industrial Average had rallied to a new all-time high of 906.30. The Rail recovery, however, was far less impressive. On January 18, the Rail Average reached a peak of 212.93, after retracing only 44% of the ground lost since its October high of 224.91. Following the Rail peak, the two Averages "parted company" with Industrials working higher while Rails declined. Letters 278 and 279 drew attention to this disconcerting action. Divergence, I wrote, particularly when accompanied by high volume, is the market's way of saying "be careful."

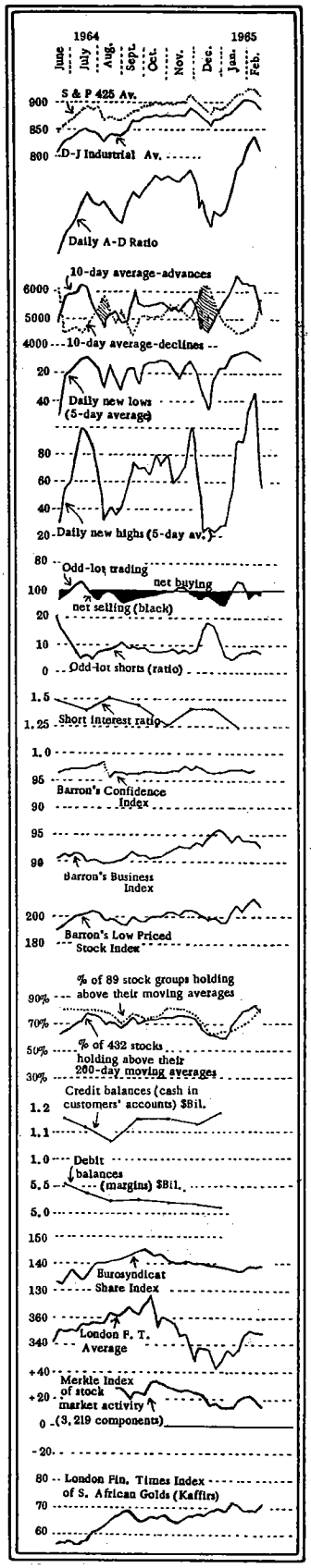
After two weeks of steady divergence, the Industrials (on February 4) elected to follow the Rails to lower levels. The announced "reason" for the decline was the worsening of the Viet Nam situation. What the actual reason for the decline was I do not know, but I will say that I have seen few genuine war scares which have failed to produce sizeable rallies in the Rail Average (hardly the case today).

What do we look for next? The 30-week moving average (M.A.) of Industrials now stands at approximately 870. This theoretical line has held during every period of market weakness since 1963. The ability or inability of the Industrial Average to hold above its M.A. will constitute a continuing test of strength or weakness. In the event of a penetration of the M.A., market students will be watching the December lows of 857.45 and 203.51. Joint penetration of these two critical points on heavy volume would signal a change in the primary trend.

CONCLUSION: It should be remembered that the last reconfirmation by the Averages occurred in October — at which time the trend was again established as clearly bullish. Under Dow Theory, a trend is conceded to remain in force until proved otherwise. This principle may seem naive in its simplicity, but it is a workable principle, and often of great use (as it is now). Therefore, unless a bear signal is given by the Averages (and the odds are always against this rare occurrence), it would be best to proceed as if we were still in an ageing but very much intact bull market.

The Composite Chart of the indicators shows the two leading industrial Averages holding just above their October-December trading ranges. The A-D ratio continues to outperform the Averages (implying, of course, that many secondary issues are outperforming the big Dow stocks). Selling pressure has come in as seen by the crossing of the 10-day averages of advances and declines. As might be expected during weakness, new highs have dropped sharply, although new lows has not yet come in (a hopeful sign). Three consecutive days of odd-lot buying have appeared this week, but this has not yet shown on the 10-day average. The fact that odd-lot shorts have not (yet) stepped up their activities during market weakness is a negative sign. The percentage of stocks and groups holding above their moving average is still well in the bull camp. The





London Average, having made up about half its October-December losses, seems to be undecided as to its next important move (perhaps it is digesting the significance of the latest whopping trade deficit). The S. African gold (Kaffirs) index has crept back to within 1 point of its 1964-65 high, and this qualifies it as one of the strongest stock averages in the world at this time.

TAKE PROFITS IN CANADIAN GOLDS? When this observer began writing about gold shares many, many months ago there were few who listened or understood. When I started writing about DeGaulle and the coming pressure on the pound and the dollar, I had even less company. But the gold story has emerged, broadened — actually erupted. Many of the gold equities are up 30 to 50% from the lows of early 1963 and 1964.

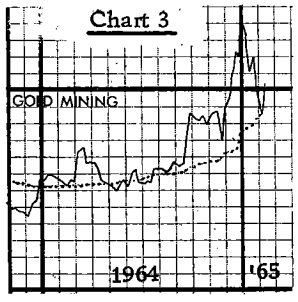
At present every Wall Street analyst has an opinion about gold and the dollar although few understand the fundamentals of the situation. Nevertheless, the gold picture is definitely out in the open. Leading analysts such as Hamilton Bolton now suggest that there is a possibility of a rise in the price of gold. Recently, the stentorian voice of Lombard, famous financial writer for the London Financial Times (and perhaps the most respected financial writer in the world) has been added to the fray. Lombard has warned the U. S. not to back itself into a corner on the gold price, and he has stated that the price of gold should be raised so substantially that it will be regarded as "really immutable" for at least 10 or 20 years. Lombard concluded recently: "In short, the U. S. authorities would do well to remember that discretion can be the better part of valor in the financial field as elsewhere before indulging in any more affirmations about immutability of the dollar price of gold."

So we now have leading authorities conceding or even suggesting that the price of gold will be raised. Furthermore, the actual trend of events continues highly favorable for rise in the gold price. For instance, over the past week France has announced a unilateral policy of settling all her international payments in gold, and France is urging all other nations to do the same. This is in keeping with DeGaulle's expressed view that the world must return to the gold standard. Furthermore, it is obvious that DeGaulle is also advocating a rise in the price of gold, since under a full gold standard there would not be enough gold (at the present price of $35 per ounce) to finance current world trade.

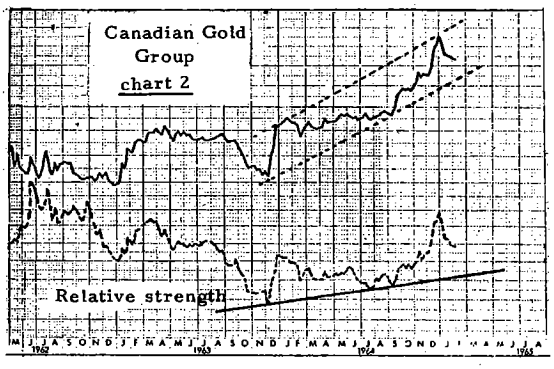
On top of all these favorable developments for gold and gold shares comes the news that the U. S. (last week) lost an additional $150 million in gold, bringing the total loss for 1965 to $450 million, and bringing the total U. S. gold stock below the $15 billion level for the first time in a quarter of a century. On the tail of the gold losses, President Johnson has announced his "cure" for the U. S. deficit situation, a watered-down list of palliatives, none of which are calculated to deal with the fundamental problems. These problems include uninhibited Government spending, continuing monetization of the debt (printing dollars) and artifically low interest rates.

Finally, the latest trade figures from England show a definite worsening of their balance-of-payments. London produced a deficit of $232 million for January compared with a $170 million deficit for December. Incredibly, British imports actually rose in January despite the 15% surcharge, while British exports declined. As if this was not bad enough, we now hear that London has promised to ease the import surcharge to 12½% within a few weeks! The evidence so far suggests that the 7% British bank rate and the 15% surcharge on imports will not do the trick. Nothing less than a full-fledged British deflation (lower wages, reduced work force, unemployment, automation) or devaluation will help England out of her present economic situation.

Nevertheless, most of the above data is now known to the market (except perhaps the full seriousness of the British predicament). To the observer, the fact that so much gold news is now in the open means that the gold shares should be watched with extra care. This is particularly true of the Canadian golds, which are selling at much higher price-earnings ratios than the S. African golds or Kaffirs. It should also be remembered that if Britain chooses devaluation, the Kaffirs will be direct beneficiaries since the S. African money unit (the rand) is directly tied to the pound (two rands equal one pound), whereas the Canadian money unit is tied to the dollar. In other words, the Kaffirs would be surer to benefit from unilateral British devaluation than would the Canadian golds.

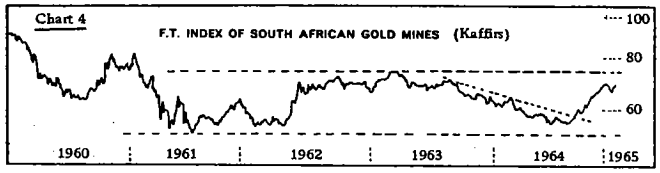


The accompanying Chart #2 shows the Canadian gold index holding within its rising channel, while its relative strength line is in a corrective phase. So far, so good, but it is well to note that following a sharp drop in relative strength, a period of waiting and reaccumulation is usually necessary. The small Chart #3 shows the Canadian gold group bouncing off its 30-week moving average, then pushing up again — also good action. In this writer's opinion, the thing to watch in the golds now is volume. In order to produce new highs the golds will have to bring in big volume again.



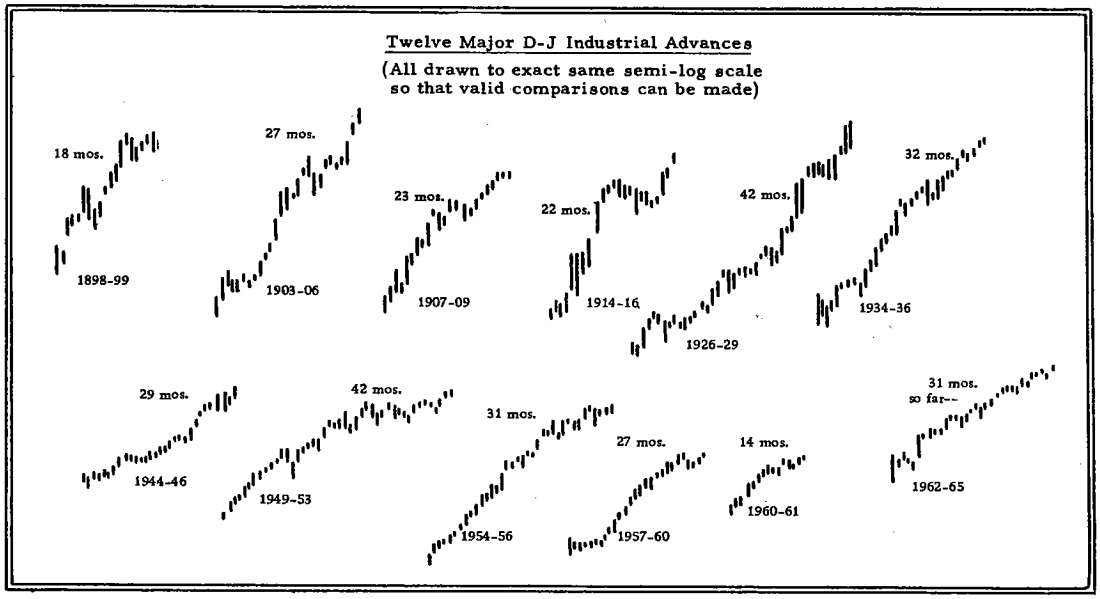
The following thought has also occupied my mind. It is possible that a worried U. S. Government (as it sees its gold stockpile melting away) will announce some dramatic policy which will cause people to say: "Ah, this is finally going to do the trick!" Such a policy would probably not be fundamental, but it could serve to knock the golds down again — perhaps to new temporary lows. I do not rule out such a possibility. For this reason, my advice is to take partial profits in Canadian golds at these advanced

prices. If the Canadian golds go to new highs, subscribers will have taken good profits and still own some golds. On the other hand, if the Canadian golds react below the last lows, subscribers will have hedged by accepting some profits near the highs.



The Kaffirs (and American South African) are another story, and I would definitely hold these. The Kaffirs index has now pushed back to within a fraction of its mid-December peak of 72 (see Chart 4). A rise in the Kaffirs index above the 1963 peak of 74 would constitute a major breakout following a four year (since 1961) base. Such a move would justify adding perhaps 20 to 40% to present holdings (and I hope that all subscribers now hold positions in such recommended issues as President Brand, Free State Geduld, Welkom, Western Deep Levels, Blyvoors, President Steyn). These are issues which provide yield of from 5 to 8%; they should be put away as a hedge against the possibility or probability of British or world devaluation.

PRIMARY TRENDS: Over the past month even our economic "liberals" have been surprised by the wave of official optimism which has swept the land. From New York to California, by radio, TV and newspaper, the American public has been told that the day of the business cycle is over. The boom is to be permanent while recessions have been rendered obsolete through the mechanism of scientific money management and controlled deficits. In the January 28 issue of the Wall Street Journal the new head of the President's Council of Economic Advisors, Mr. Gardner Ackley, was quoted as saying: "There is no natural law which requires recessions or depressions. In principle we ought to be able to prevent them." Whether Mr. Ackley has captured President Johnson's ear or vice versa we do not know, but on January 29 the Journal noted: "Washington is increasingly confident that growth can be kept up indefinitely. 'I do not believe that recessions are inevitable' the President declared."



In order to understand what is happening today, it is necessary to comprehend the principle of the primary trend. The primary trend is the all encompassing tidal force which we call a bull or a bear market. When the primary trend turns up (or down), that great trend continues until the bull or bear market has fully expressed itself. Governmental policies and actions can sometimes extend a primary trend, but they can no more reverse the trend than they can reverse the tide of the ocean. The history of primary bull or bear markets suggests that they do not die amid government pronouncements, floods, newspaper headlines, earthquakes, political tirades or Congressional investigations — they die after the last bull has bought or after the last bear has sold, when the market is exhausted.

But what of the situation today? Is the current primary advance fated to be something new under the sun? Are we indeed witnessing the birth of "The Great Society," an era which is to be composed of one perpetual bull market? Or are the President and his aides (as have so many politicians before them) simply "riding" the established primary bull trend for all it is worth? This observer is frankly not sure whether the Administration is acting out of deep-seated conviction, hope or crass desire for power. And from an investment standpoint, it matters little what our leaders' intentions are. What does matter is the odds for their success or failure.

On the accompanying chart I have drawn the twelve major extended (and relatively uninterrupted) advances in the history of the D-J Industrial Average. All advances are drawn to the same semi-logarithmic scale, and all show the monthly high and low ranges for Industrials. Because all of these advances have been set to the same scale, subscribers can compare them as to extent (in percentages) and steepness of ascent. Dates of each are printed on the chart together with the number of months which each advance lasted (so that durations too may be compared).

Note that the first six advances seem to be steeper than the later six. It is true that there was a good deal less Governmental intervention prior to the mid-1930's, and this (ironically) might account for the relatively steeper (or more powerful) rate of ascent in the earlier bull swings. Or it may be that as the Industrial Average progressed into higher territory, its rate of ascent

was subject to a normal diminishing momentum (as in the case of a high-priced vs. a low-priced stock).

It might surprise readers to note that the current (1962-65) rise has (so far) closely resembled most of the other rises. At 31 months, the present advance is a little longer than the average of the others (the previous 11 rises averaged 28 months), but otherwise it differs little from the former bull movements.

Finally, it might be well to point out that at the top of each of the previous advances the politicians were shouting about eternal prosperity and the businessmen were predicting "a good year ahead." Nevertheless, each of these bull markets were followed by bear markets of varying intensities. Some of the bear periods such as 1907 and 1938 were short but violent, some like 1929-32 were extended and severe. Still others were shallow and less painful, as for instance 1948-49. But the point is that all of these extended rises or periods of expansion were followed by major market declines and periods of economic contraction. This writer differs with the Administration in that he believes history will be repeated.

NOTES: I eat crow regarding my statement in Letter 279 on certificates of deposit. As long as the C. D. does not exceed the maximum 4½% rate, and as long as the C.D. is made in the normal manner (not through a broker or commission man), the F.D.I.C. does insure each C.D. up to $10,000. Thus C.D.'s at the San Francisco National Bank will be paid up to $10,000 (assuming they were made in the proper manner).

I wish to thank the dozens and dozens of subscribers who constantly send me fascinating articles and information from literally every corner of the earth. This little clip about Spain (from the Washington Post — sent by E. Joannides), for instance, documents a surprising and unpublicized event. The quote from Lombard in a previous section of this Letter was sent by a subscriber who takes the Star Johannesburg daily! I am sorry that I cannot thank each subscriber individually, but all efforts are most appreciated. Such courtesies allow me to write with a thousand pairs of eyes rather than one.

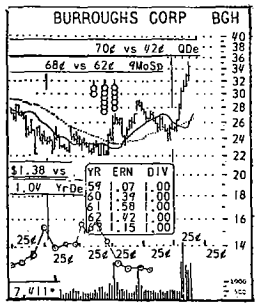
Spain Converts Dollars to Gold

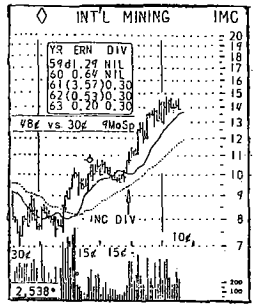
Chicago Daily News Service

MADRID, Jan. 25 — Spain quietly has begun to convert its dollar reserves to gold. A first operation involving $40,000,000 was carried out in December and it is believed a like amount is being converted this month. Further conversions are expected until Spain's gold stocks are up to 50 or 75 per cent of its total foreign exchange reserves.

The unpublicized shift to gold is presumed to be motivated by uncertainty about the dollar and pound and by speculation that the price of gold, now pegged at $35 an ounce eventually will have to be raised.

From Harry Schultz's always fascinating letter (% Courtman, 41 Hawthorn Ave., Brentwood, Essex, England, dated Feb. 11): "When I boarded S. S. France to come here I saw silver bars loaded aboard. Two weeks ago I saw 13 tons of gold ingots loaded on aircraft here bound for the Bank of France. Two similar flights made in the last fortnight. France is storing up 'nuts' for a long, hard monetary winter."

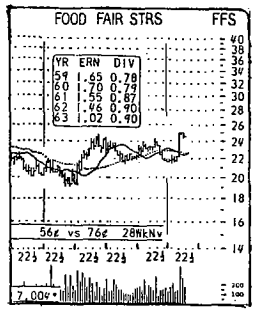




STOCKS: Burroughs which has been recommended over and over here even surprised this writer with its recent strength. In a month the stock has risen 50%! Note that BGH is now better than 33% above its 200-day moving average (the latter, the dotted line on the chart, now stands at 26½). This means that BGH could be in for a correction. Despite what I previously said, this could be a prudent time to take profits on half your commitment.

International Mining recommended in Letter 271 at 13½ has pushed out nicely this week and is finally in all-time high territory above 15. Continue to hold this one.

After declining in relative strength (R.S.) since December, 1961, the Retail Food Chain Group has finally reversed on a trend basis, and this group is now beginning to outperform the market in popularity. In the group I like Great A & P, Food Giant and Food Fair. The first two have already turned bullish and may be purchased by traders now. Food Fair has not yet turned bullish, but the bull point is 26. As seen on the monthly chart, a move to 26 on Food Fair would complete what appears to be a 2½ year base. The chart shows one very hopeful omen for FFS, and that is that a three year declining trend in R.S. has now been reversed. It remains for this stock to hit the 26 level.



LATE NOTE or perhaps this should be called a note of warning. It is unusual for the market to act well in the face of a consistently poor rail performance. I have stressed the unsatisfactory action of the rails in recent Letters, and this poor carrier action frankly bothers me. Rails (as stated before) tend to be held by the professional market element, the element which is first to sense possible forthcoming danger. Of 25 individual rail charts which I keep, I count 17 which I feel are acting poorly (on a strict relative strength basis) and 7 which are acting passably well to good. This is not a hopeful sign for the Rail Average.

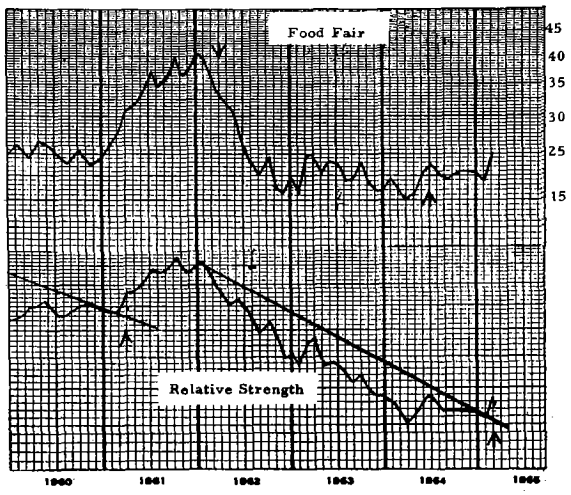


Chart of Food Fair courtesy of Ray * Signals, 141 B'way, N.Y.C. 6, N. Y.
Chart #2 courtesy of Traders Research, 1431 Pearl St., Alton, Illinois 62003.
Chart #3 courtesy of Indicator Chart Service, Palisades Park, New Jersey.
Charts of BGH and IMC and small weekly chart of FFS courtesy of Quote Digest, 110 N. Lorraine, Wichita, Kansas.